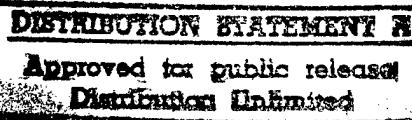


December 1997

FINANCIAL REPORTING

DOD's Fiscal Year 1996 Financial Statements Inventory Reporting Does Not Meet Standards



DTIC QUALITY INSPECTED

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Accounting and Information
Management Division

B-278326

December 24, 1997

The Honorable William J. Lynn
Under Secretary of Defense (Comptroller)
Department of Defense

Dear Mr. Lynn:

Statement of Federal Financial Accounting Standards (SFFAS) No. 3, Accounting for Inventory and Related Property, specifies different categories of tangible property for financial reporting and disclosure. Two of the asset categories applicable to the Department of Defense (DOD) under the standard are "inventory" and "operating materials and supplies." The standard, which has been in effect since fiscal year 1994, defines "inventory" as tangible personal property held for sale and "operating materials and supplies" as tangible personal property to be consumed in normal operations. In general, DOD's working capital funds typically sell items to other service activities, such as maintenance and tactical units, and, therefore, would be most likely to report inventory. DOD's general funds activities usually hold items for their own use and would most likely report operating materials and supplies.

Our objectives were to review the DOD's fiscal year 1996 financial statements to determine if its approach to reporting inventory and operating materials and supplies meets SFFAS No. 3 requirements—for individual military service financial statements as well as those at the consolidated DOD-wide level. This letter presents information on how the accounting standards are to be applied to improve the reporting of inventory and operating materials and supplies in DOD's financial statements.

Results in Brief

DOD did not fully comply with SFFAS No. 3 in fiscal year 1996. Its consolidated and component financial statements misclassified operating materials and supplies and some equipment as inventory and did not include all operating materials and supplies. For fiscal year 1996, the Army, Navy, and Air Force general fund financial statements collectively reported \$115.6 billion of inventory. The Army and Air Force did not report any amounts for operating materials and supplies and the Navy reported only \$27,000. One reason for these errors is that DOD's Guidance on Form and Content of Financial Statements for Fiscal Year 1996

Financial Activity and its accounting policy¹ misinterpreted and were not consistent with the accounting standard. As a result, DOD's fiscal year 1996 financial statements overstated inventory, understated operating materials and supplies, and overstated expenses.

About \$113.7 billion out of the \$115.6 billion reported as inventory by the general funds consisted of munitions and equipment that do not meet the SFFAS No. 3 definition of inventory and should have been classified as operating materials and supplies or plant, property, and equipment. At the same time, other items warehoused by service activities, such as repair parts and consumables, that met the SFFAS No. 3 definition of operating materials and supplies were not reported at all. We, the DOD Inspector General (IG), and the military service auditors have reported² that the military services have warehoused billions of dollars of items at bases and on ships that meet the SFFAS No. 3 definition of operating materials and supplies. However, these items were not considered as capitalized assets as required but were instead expensed on the financial statements when purchased.

The \$113.7 billion of misclassified assets represents 9 percent of total assets reported and therefore was material to DOD's fiscal year 1996 financial statements. Continued material misclassifications and underreporting will negatively affect the reliability and usefulness of the military services' and DOD's financial statements and also the auditors' opinions on those statements. DOD's guidance and accounting policies must comply with accounting standards so that inventory and operating materials and supplies are properly classified and reported in its future financial statements.

¹DOD Financial Management Regulation, DOD 7000.14-R, Volume 4, "Accounting Policies and Procedures," January 1995.

²Navy Financial Management: Improved Management of Operating Materials and Supplies Could Yield Significant Savings (GAO/AIMD-96-94, August 16, 1996); CFO Act Financial Audits: Increased Attention Must Be Given to Preparing Navy's Financial Reports (GAO/AIMD-96-7, March 27, 1996); Financial Management: Immediate Actions Needed to Improve Army Financial Operations and Controls (GAO/AFMD-92-82, August 7, 1992); Internal Controls and Compliance With Laws and Regulations for the DOD Consolidated Financial Statements for FY 1996 (DOD IG Report No. 97-182, June 30, 1997); Army's Principal Financial Statements for Fiscal Year 1996 and 1995 Report on Internal Controls and Compliance With Laws and Regulations (AAA Report No. AA 97-145, 30 June 1997); Opinion on Fiscal Year 1996 Air Force Consolidated Financial Statements (AFAA Report No. 96053001, 1 March 1997); Department of the Navy Fiscal Year 1996 Annual Financial Report: Report on Internal Controls and Compliance With Laws and Regulations (NAS Report No. 029-97, 15 April 1997).

Objectives, Scope, and Methodology

Our objectives were to determine whether DOD, in its fiscal year 1996 financial statements, (1) properly classified inventory and related property according to SFFAS No. 3 requirements, (2) reported fully its operating materials and supplies, and (3) had appropriate reporting guidance and accounting policy to ensure proper reporting and classification of inventory and related property.

To determine whether DOD properly classified inventory and related property and reported fully its operating materials and supplies, we reviewed SFFAS No. 3 and then compared its requirements with DOD's fiscal year 1996 consolidated financial statements and the individual Army, Air Force, and Navy fiscal year 1996 financial statements. Further, we reviewed the DOD IG and military service auditors' reports on these financial statements.

To determine whether DOD's guidance and accounting policy were appropriate, we compared its Guidance on Form and Content of Financial Statements for FY 1996 Financial Activity and Financial Management Regulation, Volumes 4 and 11B, with SFFAS No. 3 requirements. In addition, we reviewed Federal Accounting Standards Advisory Board (FASAB) deliberations and decisions.

We performed our review from June 1997 through October 1997 in accordance with generally accepted government auditing standards. We requested written comments on a draft of this report from the Department of Defense. On December 9, 1997, the Principal Deputy Under Secretary of Defense (Comptroller) provided us with comments, which are discussed in the "Agency Comments and Our Evaluation" section and are reprinted in appendix I.

Assets Misclassified as Inventory Held for Sale

SFFAS No. 3 defines inventory as tangible personal property that is (1) held for sale, (2) in the process of production for sale, or (3) to be used in the production of goods for sale or in the provision of services for a fee. However, in the \$115.6 billion reported in their fiscal year 1996 general fund financial statements as inventory, the Army, Navy, and Air Force erroneously included \$113.7 billion of munitions, spare parts, and equipment (such as tank and howitzer subassemblies) that were held for the services' own use and were not for sale to others. These items should have been classified as operating materials and supplies or property, plant, and equipment. Army and Air Force auditors cited these misclassifications of assets in their fiscal year 1996 financial statement audit reports.

According to the DOD IG, almost \$74 billion of the misclassifications were war reserves, which include ammunition, missiles, and munitions related items. Only the Army's Conventional Ammunition Working Capital Fund, which held \$1.9 billion of ammunition for sale, was appropriately classified as inventory.

The following table, which is based on the component financial statements and DOD IG and service auditor information, shows the misclassified inventory by type and service.

Table 1: DOD Misclassified Inventory Reported in Fiscal Year 1996

Dollars in billions				
Asset type	Army	Navy	Air Force	Total
Equipment & other items	\$12.8	\$18.7	\$19.1	\$50.6
Munitions	\$22.9	\$22.8	\$17.4	\$63.1
Total reported	\$35.8	\$41.4	\$36.5	\$113.7

Note: Although the Navy's financial statement reported \$22.8 billion of ammunition, the Naval Audit Service reported that the Navy improperly included at least \$11.6 billion of ammunition due to a computer software problem. In addition, the Air Force Audit Agency reported that the Air Force had overstated the reported \$17.4 billion of munitions by \$853 million. Totals are not precise due to rounding.

For fiscal year 1996, the Army, Navy, and Air Force were following DOD guidance when they reported munitions and equipment as inventory. However, DOD's fiscal year 1996 form and content guidance, which is intended to supplement the Office of Management and Budget (OMB) form and content guidance,³ is not consistent with SFFAS No. 3 or OMB guidance. DOD's guidance states that the inventory line item should include equipment purchased with procurement funds and war reserve items that are held in wholesale or retail supply inventories. However, these items include equipment and ammunition that are not held for sale to others. For example, according to Army auditors, the Army's fiscal year 1996 financial statements inventory line erroneously included tanks and howitzers that are stored at depots and issued to Army units without reimbursement.

In addition, both SFFAS No. 3 and OMB requirements for preparing financial statements provide an operating materials and supplies subcategory for items that are held in reserve for future use. This subcategory would be the proper place to report munitions owned by the services and held in storage by DOD.

³OMB Bulletin No. 94-01, "Form and Content of Agency Financial Statements," issued November 16, 1993, effective for the fiscal year ending September 30, 1994.

Operating Materials and Supplies Were Not Reported

According to SFFAS No. 3, operating materials and supplies consist of tangible personal property to be consumed in normal operations. The standard requires that expenses for operating materials and supplies be recognized when items are issued to the end user (the consumption method of accounting) unless (1) operating materials and supplies are not significant amounts, (2) they are in the hands of the end user for use in normal operations, or (3) it is not cost-beneficial to apply the consumption method of accounting. To clarify the term "end user," SFFAS No. 3 specifically states that "any component of a reporting entity, including contractors, that maintains or stocks operating materials and supplies for future issuance shall not be considered an end user."

For the most part, DOD accounting policy is consistent with SFFAS No. 3 regarding the definition of operating materials and supplies, and it specifies that the consumption method should ordinarily be used to recognize expenses for operating materials and supplies. Further, the DOD Materiel Management Regulation, DOD 4140.1-R, defines end user as "that individual or organizational element authorized to use supply items. This is normally the terminal point in the logistics system at which action is initiated to obtain materiel required for the accomplishment of an assigned mission or task." However, the accounting policy has not been properly implemented at the military service level. In practice, DOD components have improperly expensed significant amounts of operating materials and supplies before distributing them to the end users. As a result, DOD is not fully recognizing and reporting all operating materials and supplies according to the accounting standard and its own regulation and is overstating its expenses or net position. This practice can also contribute to DOD managers not having complete information on assets for budgeting and purchasing decisions.

As shown in the following table, which is based on information reported for fiscal year 1996, operating materials and supplies were underreported by about \$79 billion.

Table 2: Fiscal Year 1996 Unreported Operating Materials and Supplies

Dollars in billions				
Component	Misclassified munitions	Account overstatement	Account understatement	Total
Army	\$22.9	–	–	\$22.9
Navy	\$22.8	\$11.6	\$20.5	\$31.7
	–	–	\$7.8	\$ 7.8
Air Force	\$17.4	\$ 0.9	–	\$16.5
Total	\$63.1	\$12.5	\$28.3	\$78.9

As shown in table 2, munitions totaling \$50.6 billion (\$63.1 billion adjusted for the \$12.5 billion of munitions overstatements reported by the military service auditors) should have been classified as operating materials and supplies. Further, the Naval Audit Service reported that the Navy did not report an additional \$20.5 billion of ammunition.⁴ According to the auditors, the Navy also had an estimated \$7.8 billion of unreported operating materials and supplies in storage on board ships and at Marine Corps activities. For example, combat ships, such as frigates and cruisers, hold material in storerooms until the work centers requisition items for repair work or other uses. Navy supply officers store operating materials and supplies at shore locations for subsequent issuance to aircraft carriers and submarines.

Similarly, according to Army auditors, Army divisions could have unreported operating materials and supplies. Army divisions are authorized to store about \$800 million of equipment components and repair parts for aircraft, missiles, and common equipment (e.g., trucks, tanks, and generators) in storage for future issuance to combat units. Because Army auditors did not determine how much was on hand, DOD does not know whether the Army divisions were holding their authorized levels, or more or less than their authorized levels at year-end. As a result, we could not estimate Army's understatement of operating materials and supplies.

Confusion regarding categorization of operating materials and supplies may result from a DOD time limitation on holding operating materials and supplies. SFFAS No. 3 does not directly address time limitations for holding operating materials and supplies. However, the description of the required disclosure subcategories—(1) held for use, (2) held in reserve for future use, and (3) excess, obsolete, and unserviceable—indicates that operating

⁴Department of the Navy Fiscal Year 1996 Annual Financial Report: Ammunition and Ashore Inventory (NAS Report No. 048-97, 25 September 1997).

materials and supplies could be held for several months or even several years. DOD Financial Management Regulation, DOD 7000.14-R, Volume 4, "Accounting Policies and Procedures," states that items classified as operating materials and supplies held for current and future use "shall not exceed the amount expected to be used within 30 days unless justifying documentation supporting a supply in excess of 30 days is developed and maintained for review."

DOD's policy restriction could mean an additional, unnecessary documentation burden for service activities to justify keeping munitions, which are included in war reserves, and other items in storage for more than 30 days. The conflict between war reserves and the 30-day restriction for operating materials and supplies may discourage the services from complying with the accounting policy and may contribute to their not recognizing billions of dollars of operating materials and supplies.

Conclusion

DOD's financial reporting would be improved if its guidance and policies were made consistent with accounting standards and modified so that they do not unduly restrict reporting requirements. By making some policy changes, DOD could clarify its asset reporting categories and thereby minimize inconsistencies and underreporting in component and consolidated financial statements.

Recommendations

We recommend that you

- revise DOD's Guidance on Form and Content of Financial Statements to include as inventory only those items that are held for sale, consistent with SFFAS No. 3;
- clarify DOD's Financial Management Regulation on the documentation and reporting requirements for operating materials and supplies; and
- monitor the services' and the Defense Finance and Accounting Service's implementation of the guidance and policy to ensure that (1) amounts are properly classified between SFFAS No. 3 reporting categories and (2) operating materials and supplies, which includes munitions and other material held in storage at all organization levels, are recognized and reported as assets in DOD's financial statements.

Agency Comments and Our Evaluation

The Principal Deputy Under Secretary of Defense (Comptroller) concurred with our finding that DOD's form and content guidance

concerning inventory reporting for fiscal year 1996 was incorrect and, as a result, that items not held for sale were misclassified as inventory. The Deputy Comptroller stated that DOD's final guidance for the fiscal year 1997 financial statements has been corrected and it now requires that inventory consist only of items that are held for sale.

The Deputy Comptroller also stated that DOD partially concurred with our two other findings. However, we do not find the Deputy Comptroller's comments responsive to our recommendations regarding the need for clarifying and enforcing DOD guidance for reporting operating materials and supplies. While the Deputy Comptroller's response points to a lack of specific FASAB guidance for reporting "war reserves" (consisting mainly of munitions and equipment), it does not address unreported operating materials and supplies warehoused on ships, at shore locations, or at other storage facilities awaiting issuance to end users. As stated earlier in this report, nearly \$8 billion of Navy's operating materials and supplies were not reported in fiscal year 1996. Unless DOD clarifies and enforces guidance requiring capitalization of warehoused operating materials and supplies, we expect such underreporting of assets to continue.

In regard to the Deputy Comptroller's assertion that FASAB has not issued authoritative guidance specifically addressing munitions, we note that the standards are intended to describe the general characteristics of various asset types that need to be applied across a variety of government operations. They are not intended, nor is it practical, to list every item and how it should be reported. SFFAS No. 3 provides broad criteria for the reporting of operating materials and supplies that clearly apply to munitions. In our report on the liability associated with the disposal of conventional ammunition,⁵ we noted that FASAB had recently reviewed the asset category for ammunition and reiterated its position that ammunition should be classified as operating materials and supplies. FASAB announced this decision in its September 1997 newsletter. In addition, the Deputy Comptroller stated that we inappropriately cited FASAB deliberations as authoritative guidance. We have clarified the report to indicate that we reviewed FASAB deliberations and decisions. We did not find any justification for DOD's position that the reporting requirements for munitions were not clear.

The Deputy Comptroller's response did not specify how DOD's war reserve items, which the DOD IG reported had been misclassified, will be reported

⁵Financial Management: DOD's Liability for the Disposal of Conventional Ammunition Can Be Estimated (GAO/AIMD-98-32, December 19, 1997).

in fiscal year 1997. The FASAB standards and OMB form and content guidance call for munitions to be classified as operating materials and supplies and war reserve equipment to be classified as property, plant, and equipment.

We are sending copies of this letter to the Chairmen and Ranking Minority Members of the Senate Committees on Governmental Affairs and Armed Services, the House Committees on Government Reform and Oversight and National Security, and the Director of the Office of Management and Budget. Copies will be made available to others upon request.

Major contributors to this report are Molly Boyle and Alan Steiner. Please contact me at (202) 512-9095 if you have any questions on this report.

Sincerely yours,



Lisa G. Jacobson
Director
Defense Financial Audits

Comments From the Department of Defense


COMPTROLLER

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DEC - 9

Mr. Gene L. Dodaro
Assistant Comptroller General
Accounting and Information
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U.S. General Accounting Office
Washington, DC 20548

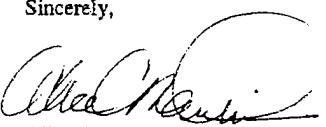
Dear Mr. Dodaro:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) Draft Report, "FINANCIAL REPORTING: DoD's Fiscal Year 1996 Financial Statements Inventory Reporting Does Not Meet Standards," dated October 24, 1997 (GAO Code 919157, OSD Case 1482).

This office concurs with the report's finding that only items held for sale should be reported as inventory. However, this office believes that authoritative guidance issued to date by the Office of Management and Budget (OMB), including the SFFAS No. 3 and the OMB's "Form and Content of Agency Financial Statements," does not explicitly address financial statement reporting of the Department's war reserves. Given the absence of explicit Federal Accounting Standards Advisory Board accounting standards and OMB issued federal-wide report guidance, the Department is reluctant to arbitrarily distribute war reserve materiel between various asset lines on the Statement of Financial Position. Therefore, this office concurs with recommendation 1 and partially concurs with recommendations 2 and 3. The enclosure contains more detailed responses to each of those recommendations.

The Department appreciates the opportunity to comment on the draft report.

Sincerely,


Alice C. Maroni
Principal Deputy Under
Secretary of Defense (Comptroller)

Enclosure

GAO DRAFT REPORT - DATED OCTOBER 24, 1997
OSD CASE 1482, GAO CODE 919157

"FINANCIAL REPORTING: DOD'S FISCAL YEAR 1996 FINANCIAL STATEMENTS INVENTORY REPORTING DOES NOT MEET STANDARDS"

**DEPARTMENT OF DEFENSE COMMENTS ON
THE TECHNICAL ACCURACY OF THE DRAFT REPORT**

As the GAO is aware the Department agrees that only items held for sale should be reported as inventory and is revising its reporting guidance.

Page 5, second paragraph states, "To determine whether DoD's guidance and accounting policy were appropriate, we compared its Guidance on Form and Content of Financial Statements for FY 1996 Financial Activity and Financial Management Regulation, Volumes 4 and 11B, with SFFAS No. 3 requirements and Federal Accounting Standards Advisory Board deliberations and decisions, specifically regarding the reporting of munitions." The Department recognizes that Statements of Federal Financial Accounting Standards (SFFAS) are authoritative guidance because they were formally recommended by the Federal Accounting Standards Advisory Board (FASAB) and approved by the Office of Management and Budget (OMB). However, the SFFAS No. 3 does not specifically address munitions; therefore, there is a need for clarification. Additionally, "deliberations" of the FASAB do not represent authoritative guidance. Instead they are merely predecisional discussions that may (or may not) result in a particular formal standard. Accordingly, until the FASAB issues a formal standard--and at the time of the GAO report the FASAB had not even issued a draft standard for comment/consideration--it is not appropriate for the GAO to cite--as authoritative guidance--deliberations and discussions of the FASAB members. While the General Accounting Office (GAO) may offer its opinion concerning the treatment of munitions, it is a misrepresentation of the facts to imply that the FASAB and the OMB have issued guidance with respect to the reporting of munitions.

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DEPARTMENT OF DEFENSE COMMENTS ON
THE GAO RECOMMENDATIONS

RECOMMENDATION 1: The GAO recommended that the Under Secretary of Defense (Comptroller) revise DoD's Guidance on Form and Content of Financial Statements to include as inventory only those items that are held for sale, consistent with the SFFAS No. 3. (p. 12/GAO Draft Report)

DOD RESPONSE: Concur. The final guidance for "DoD Form and Content for Audited Financial Statements for FY 1997" requires that only items held for sale be reported on the Inventory line of the Statement of Financial Position.

RECOMMENDATION 2: The GAO recommended that the Under Secretary of Defense (Comptroller) clarify DoD's Financial Management Regulation on the documentation and reporting requirements for operating materials and supplies. (p. 12/GAO Draft Report)

DOD RESPONSE: Partially concur. As the GAO is aware, the Office of the Under Secretary of Defense (Comptroller) is in the process of updating the "DoD Financial Management Regulation" (DoD 7000.14-R) to incorporate all federal-wide accounting standards--to include the reporting of operating materials and supplies--recommended by the FASAB and adopted by the OMB. However, this office believes that authoritative guidance issued to date by the OMB, including the SFFAS No. 3 and the OMB's "Form and Content of Agency Financial Statements," does not explicitly address all of the categories addressed in the GAO report. Thus, this office plans to seek resolution of applicable issues with the appropriate authoritative body, such as the FASAB, the Accounting and Auditing Policy Committee, or the OMB.

RECOMMENDATION 3: The GAO recommended that the Under Secretary of Defense (Comptroller) monitor the Services and the Defense Finance and Accounting Service (DFAS) to ensure that (1) amounts are properly classified between SFFAS No. 3 reporting categories, and (2) operating materials and supplies, which includes munitions and other materiel held in storage at all organization levels, are recognized and reported as assets in DoD's financial statements. (p. 12/GAO Draft Report)

DOD RESPONSE: Partially concur. This office will monitor the implementation of the guidance and policy by the Services and the DFAS concerning the accounting and reporting of operating materials and supplies. However, this office believes that authoritative guidance issued to date by the OMB, including the SFFAS No. 3 and the OMB's "Form and Content of Agency Financial Statements," does not explicitly address all of the categories addressed in the GAO report. Thus, this office plans to seek resolution with the appropriate authoritative body, such as the FASAB, the Accounting and Auditing Policy Committee, or the OMB.

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